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INFO RUCNSAD/SOUTHERN AF DEVELOPMENT COMMUNITY COLLECTIVE
RUEHLO/AMEMBASSY LONDON 0394
RHMFISS/CDR USAFRICOM STUTTGART GE
RUEATRS/DEPT OF TREASURY WASH DC
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UNCLAS SECTION 01 OF 03 LILONGWE 000489

SENSITIVE
SIPDIS

LONDON FOR AF WATCHER P. LORD

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TAGS: EFIN EAID PGOV MI
SUBJECT: MALAWI: CURRENCY PEG PROMPTS BALANCE OF PAYMENTS CRUNCH

REF: A. LILONGWE 283
¶B. LILONGWE 387

LILONGWE 00000489 001.2 OF 003

Classified By: Charge Kevin K. Sullivan for reasons 1.4 (b) and (d).

¶1. (SBU) Summary: Malawi's foreign exchange reserves have dipped below the level of one month's import coverage, prompting central bank officials to request urgent donor assistance. The IMF has plans to send a new mission to Malawi in October, but the Fund wants to see a coherent GOM exchange rate strategy before offering additional support. The Malawian Kwacha has been informally pegged at 141 per dollar for over two years and market experts believe it is overvalued by at least 20 percent. Reserve Bank officials are already rationing foreign exchange through private banks, and reports suggest that the scarcity of forex has put a number of investment projects on hold. President Mutharika has defied expectations that he would allow some exchange rate adjustment following the May 2009 national elections, arguing that devaluation would spark inflation and hurt ordinary Malawians. Private sector observers agree that devaluation would harm some businesses and create inflationary pressures, but see little alternative. Increasing shortages of imported products in Malawi may also ratchet up the pressure on Malawi's Economist in Chief. End Summary.

FOREX DOWN TO ONE MONTH COVERAGE

¶2. (SBU) High-level officials at the Reserve Bank of Malawi, the country's central bank, told the Ambassador and emboffs on Aug. 27 that Malawi's foreign exchange reserves had dwindled to a level sufficient to offer less than one month's import cover. Deputy Governor Mary Nkosi noted that the scarcity of foreign exchange was occurring at precisely the time of year -- the end of the tobacco auction season -- when Malawi's reserves usually peak. (Note: Over the past several years the Bank has generally maintained reserves at between two and three months' import cover, with annual fluctuations responding to the country's agricultural cycle. Foreign aid, including both project-based and direct budget support, constitute Malawi's main source of forex apart from tobacco receipts. End note.) The officials indicated that the Reserve Bank had been forced to ration what hard currency was available for priority transactions involving fuel and

fertilizer imports, pharmaceuticals and capital goods and inputs for manufacturing. For private transactions, the Bank relied upon commercial banking partners to prioritize among their many clients. Bank officials acknowledged that some corruption was likely occurring during this rationing process.

SPECULATION AND ECONOMIC GROWTH BOTH FACTORS

¶3. (SBU) Wilson Banda, chief of the Bank's Operations Division, claimed that a good portion of the increased demand for hard currency was due to market speculation. Expectations that a devaluation would follow soon after Malawi's national elections in May had put pressure on the kwacha since early in the year, and that pressure had intensified as speculators saw no devaluation had occurred, and that reserve levels remained low late into the tobacco season. Banda admitted, however, that a good part of the demand for forex was genuine rather than speculative. Malawi's strong economic growth in recent years had increased the demand for imports of both consumption and investment goods. This consistent growth was clearly a positive development, Banda argued, and should not be punished by Malawi's development partners. The Reserve Bank official noted that decline in global tobacco prices during this same period meant that the current account deficit would inevitably widen. Banda noted ruefully that a new uranium mining project had not yielded the forex benefits that the Bank had anticipated because of the way the company, Palladin, had structured its finance and marketing operations.

PRESIDENT DIGS IN ON EXCHANGE RATE

¶4. (SBU) Deputy Governor Nkosi observed that President Bingu wa Mutharika, who was reelected in a landslide in May (ref A), had stated publicly after the election that "the exchange rate will not move." (Note: While Malawi's 1993 constitution assigns the Reserve Bank exclusive authority for managing Malawi's foreign exchange and monetary policy, the Executive Branch has routinely played a decisive role in these policies. End Note.) In line with the President's thinking, Banda argued that Malawi would gain little through a devaluation. He claimed that an exchange rate adjustment would be unlikely to affect either the supply of dollars or the demand for them significantly. He pointed out that most of Malawi's dollar purchases were for fuel, fertilizer and other essential items. Pressing for a decline in demand for dollars was tantamount to slowing the economic growth that the country needed, he claimed.

¶5. (SBU) Banda asked for the Ambassador's assistance in accelerating inflows from the IMF and other donors to alleviate pressure on the Kwacha. The Ambassador replied that donors were unlikely to dedicate additional resources to support what most observers considered a significantly over-valued exchange rate. When DCM pointed out that an IMF Mission was due in Malawi in October, Banda argued that the Fund was moving much too slowly given Malawi's needs.

IMF: NO MORE SUPPORT WITHOUT STRATEGY

¶6. (SBU) IMF Resident Representative (ResRep) Maitland MacFarlane told DCM Aug. 27 that the Fund's plans for an October mission to Malawi were on hold. He noted that Malawi's current Fund facility was due to conclude in December, and that the GOM had expressed an interest in a new, medium-term facility thereafter. The problem was that the GOM had broken the fundamental commitments it had given

to the Fund in order to secure its current program, including one to allow some adjustment in the exchange rate after the May election. These commitments had been made by former Finance Minister Goodall Gondwe to the IMF's deputy Managing Director earlier in 2009. Gondwe had since been replaced by Ken Kandodo, and the only word from the GOM post-election had been the President's public vow to uphold the current kwacha/dollar rate.

¶7. (SBU) MacFarlane explained that the Fund would not dictate to any country what its exchange rate should be, but would require a set of economic policies that would be consistent with a given rate. In the case of Malawi, he said, such policies would necessarily include budget cuts equivalent to roughly 2 percent of its GDP -- something the GOM has shown no inclination to pursue (ref B). The Resrep told DCM that the IMF would not send out a full mission to negotiate a new facility with the GOM until the GOM articulated a coherent strategy for whatever exchange rate regime it wished to implement. He noted that the GOM had recently canceled a meeting that had been scheduled for President Mutharika with the Fund's Deputy Managing Director in September, dashing hopes that the meeting might provide the necessary high-level commitments and policy direction to underpin a new program for Malawi. The only other such opportunity on the horizon would be the Annual IMF Board meetings scheduled for early October in Istanbul. Absent a clear policy framework, MacFarlane suggested the Fund might send its new Malawi director, Jane Stotsky to engage the GOM in a general way, but without a team or mandate to negotiate a new program.

PRIVATE SECTOR: DISRUPTION AND UNCERTAINTY

¶8. (SBU) Several of the Malawian financial sector's major players shared with emboffs their concerns about the future of Malawi's informally fixed exchange rate. Most believed that some adjustment was inevitable, though some hoped the President would continue to hold firm. Those favoring the status quo said they agreed with the President's arguments

that 1) devaluation would bring higher inflation; and 2) many businesses might go under, and economic growth would be compromised. A majority favored some kind of gradual adjustment of the dollar rate to relieve chronic shortages of hard currency, and to provide incentives for the kind of capital investments that could increase Malawi's capacity to increase exports in the longer term. Matthews Chikoanda, the chairman of one of Malawi's largest conglomerates and a former minister of finance, reported that even existing investments, such his company's cellular telephone company, could not reliably access dollars to expand their infrastructure. Figures released by the Malawi Confederation of Chambers of Commerce and Industry show that over $50 million was owed to foreign suppliers, and accumulating interest charges, at the end of June 2009.

¶9. (SBU) Asked who was making economic policy in the President's new government, most private sector leaders were at a loss. Most suspected the President, who is an economist, was making most major decisions himself. Chikoanda claimed that Mutharika was getting conflicting advice from advisors about the exchange rate, and no longer had the authoritative voice of former Finance Minister Gondwe to sort through competing notions. He noted that the GOM had been unable to recruit a replacement for the Governor of the Reserve Bank, who had left the position in June. Other business leaders wondered aloud who would be willing to take the job under current conditions. Chikoanda also suggested that for its part, the IMF was now poorly positioned to put pressure on the GOM for better policies after it had basically given President Mutharika a pass in the run up to elections. Another banker remarked that while the Fund had given Malawi roughly $80 million dollars in support earlier

in the year, the package was quite small compared with those given to other African countries, and reflected concerns about Malawi's situation.

FOREX BUREAUS CLOSED, SMUGGLERS ARRESTED

¶10. (SBU) Instead of devaluing the kwacha to reduce demand for dollars, or offering a solid economic justification for maintaining the current exchange rate the GOM, and Mutharika personally, has engaged in high-profile public criticism of 'unscrupulous' foreign exchange bureaus and illegal currency smugglers. Increased police operations against black market traders and smugglers since the election have resulted in the arrest of two Chinese nationals carrying large amounts of dollars at Lilongwe's international airport. On August 3 the RBM closed nearly all formerly legal foreign exchange bureaus. (Comment: It is unlikely that smuggling is occurring on a scale sufficient to account for Malawi's forex shortage. The GOM's crackdown is most likely intended to shift blame for forex shortages away from the government, while at the same time asserting additional control over trading. End Comment)

COMMENT: BINGU THE CONTRARIAN TO BE TESTED

¶11. (SBU) President Mutharika has taken pleasure in challenging economic orthodoxy on a number of fronts, including his signature fertilizer subsidy program and his floor prices for agricultural commodities. His insistence on a fixed kwacha dollar rate in the face of mounting balance of payments problems is consistent with this contrarian approach. The IMF will face some difficult decisions in the coming months concerning whether and how to use its leverage to push for greater flexibility and coherence in Malawi's exchange rate policy. Increasing shortages of imported products in Malawi may also ratchet up the pressure on Malawi's Economist in Chief.
SULLIVAN